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ABSTRACT

In the 1980 election year, Congress is likely to provide taxpayers with some form of tax savings, and observers predict that legislators will begin efforts to modify the Internal Revenue Code to provide more equity, gather more revenues, and serve a number of other purposes that will affect the higher education community. Particularly, higher education institutions will seek to preserve and broaden the provision that allows charitable contributions to colleges and universities to be deducted in calculating a donor's income tax. In addition, they have a strong interest in maintaining the tax-exempt status of scholarships and fellowships (Section 117). Tuition remission, presently regarded as tax-exempt, may be vulnerable during the tax review process. The concept of tax expenditures is fundamental to the arguments on tax reform. Legislative history, cultural values, and current politics argue against any wholesale reform of the tax code, and yet piecemeal efforts to alter the code have been made and will continue. The higher education community views these efforts with concern, but has a powerful ally in other special interest groups, particularly in the nonprofit sector, that are also interested in encouragement of charitable giving. (Author/MSP)

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TAXATION: EQUITY AND POLITICS IN HIGHER EDUCATION

By Carol Herrnstadt Shulman

In this election year, Congress is likely to provide taxpayers with some form of tax savings. In 1981, Congressional observers predict that legislators will begin efforts to modify the Internal Revenue Code to provide more equity, gather more revenues, and serve a number of other purposes.

These activities will affect the higher education community. As financially-pressed organizations, higher education institutions have a considerable stake in retaining and building upon the present provisions in the tax code that work for their financial well-being. Most particularly, they seek to preserve and broaden the provision that allows charitable contributions to colleges and universities to be deducted in calculating a donor's income tax. They argue that this benefit is a major incentive for higher education philanthropy.

In addition, colleges and universities have a strong interest in maintaining the tax-exempt status of scholarships and fellowships (Section 117). Tuition remission, presently regarded as tax-exempt, may be vulnerable during the tax review process.

Whenever Congress looks at the tax code, colleges and universities are keen observers of and active participants in the discussions and are deeply concerned about what changes are made. During this year and next, the issues cited above—the fate of the charitable deduction, treatment of tuition remission, and treatment of fellowships and scholarships—will go before Congress. This *Research Currents* examines current views on taxation and how they influence these issues, and particularly arguments the higher education community presents to further its needs through the tax code.

Reviewing the Internal Revenue Code

> Taxation is, for most taxpayers, inevitable and unwelcome. Yet the unpopular work carried on by the bulk of the federal tax system provides its own counterpoint—the appealing prospect of tax relief. With substantial taxation the general rule for all society, provisions that spare particular citizens and organizations from taxation are highly prized (Kirkwood and Mundel 1975, p. 142).

These provisions, so dear to the taxpayer, arouse strong feelings and foster lobbying efforts whenever the prospect of changing the Internal Revenue Code occurs.

Since the late 1960's, the most significant threat to these provisions comes from a theory on taxation and the federal budget that treats income-tax deductions as "tax expenditures." Developed by Stanley S. Surrey, then Assistant Secretary of the Treasury for Tax Policy, this concept underlies efforts to modify or make major reforms in the Internal Revenue Code.

Basically, the tax expenditure concept looks at the totality of revenue produced in this country for personal use. *First,* it postulates an ideal income-tax structure in which taxation is levied on net income, which is "the best approximate measure of ability to pay" (National Association of Independent Colleges and Universities et al. 1978, p. 3).* Net income is the income remaining after certain "income-defining" deductions are subtracted from gross income. These deductions are generally limited to expenses necessary for earning or producing income, such as travel expenses or uniform purchases. Any other deductions from gross income, *e.g.* Social Security taxes, state and local nonbusiness taxes, and charitable gifts, represent a departure from the ideal income-tax structure: their justification lies elsewhere, in the need to meet certain social or economic objectives. But under the tax expenditure theory, these deductions are considered revenue lost to the federal government.**

Second, the tax expenditure concept holds that these departures from the ideal tax system must be accounted for in the budgetary process when total federal expenditures are considered. Since deductions sanctioned by Congress reduce federal revenues, so the argument goes, they are indirect spending programs, and therefore they influence public policy and should be included in the federal budget.

Until 1968, only those expenditures directly approved by Congress through the appropriations process were included in the federal budget. But since then, the federal government has gradually adopted the tax-expenditure approach. The Department of the Treasury has published a "Tax Expenditure Budget" since 1968; and, under the Budget Act of 1974, the federal budget lists certain tax expenditures and estimates of the revenue they would generate if collected.

Despite its pervasive influence, the tax-expenditure concept is not without its dissenters. Some commentators argue that this concept subverts the nation's fundamental belief in the right to private property:

> *[Its advocates] are implicitly asserting that all income covered by the general provisions of the tax laws belongs of right to the government, and that what the government decides, by exemption or qualification, not to collect in taxes constitutes a subsidy* (Kristol 1974, p. 15. Emphasis in original).

Furthermore, they contend that the tax expenditure concept is inappropriate when applied to the charitable deduction because its theory of "income definition" goes against historical tradition and cultural values:

> at the core of the only definition of income that has the benefit of consensus, there is a concept of consumption . . . [which] certainly consists of what one spends on food, shelter and clothing . . . what one saves to pass on to heirs. . . . But 2,000 years of religious, philosophical and ethical views suggest that what one gives to charity can properly be viewed differently (Filer 1975 p. 110, citing Bittker).

From a practical perspective, the development and general acceptance of a "Tax Expenditure Budget" subjects the permitted deductions to continual scrutiny. In fact, current efforts to pass "sunset" legislation illustrate just how the tax-expenditure concept makes vulnerable deductions that are of interest

*The following explanation of "tax expenditure" is based on the NAICU discussion.

**For example, in 1972, the estimated tax expenditure, or revenue the government did not receive, for all of education was $275 million (Kirkwood and Mundel 1975).

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to higher education. Sunset legislation would require Congress to review and to decide whether to continually modify or terminate programs. If Congress failed to affirmatively reauthorize their continuance, the programs would automatically terminate or suffer other penalties. Several bills now before the House include "tax expenditures" in the same category as federal programs, thereby making them candidates for modification or termination. For example, H.R. 5858, sponsored by Congressman Gillis Long, proposes to *"establish a procedure for the periodic sunset review of Federal programs and tax expenditures by the Congress* (p. 2., emphasis added.) If enacted, such legislation would threaten the termination of deductions for charitable giving and scholarships. Equally important, it would create considerable problems for college and university fund-raising drives: the possible expiration of deductions advantageous to charitable giving might slow and possibly reduce contributions because of the difficulties involved in estate planning. The testator would be uncertain about the net cost of charitable giving and the net amount of estate tax liability. These problems may surface several years before the end of a reauthorization cycle (Boskin 1979).

Section 501 (c) (3)

Most discussions on tax policy and higher education center around Section 501 (c) (3) of the Internal Revenue Code. Questions of politics, equity, and finance all come into play in these debates. Supporters of this section argue that the deductions it grants are extremely helpful in continuing the financial well-being of colleges and universities, both public and private. Critics contend that it provides unfair tax advantages to the wealthy at the expense of other citizens and that it results in revenue lost to the federal government that should be used in government-approved programs (the tax-expenditure argument).

This discussion describes the basic workings of Section 501 (c) (3), its benefits to colleges and universities, and the upcoming debates on "above-the-line" legislation for charitable contributions.

How It Works

Section 501, enacted in 1917, singles out certain organizations for special tax treatment. Section 501 (a) exempts from federal income tax those organizations described in Section 501 (c) (3), which include: "Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, . . . literary or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual." Other sections of the Internal Revenue Code elevate the importance of Section 501 (c) (3): they *provide that such organizations are "eligible to receive gifts and bequests that are deductible in computing the income, gift, and estate tax liabilities of the donors"* (Persons et al. 1977, p. 1909, emphasis added).

Given the present tax structure, this system of deductions provides substantial tax advantages to those in the highest income brackets and progressively diminishing returns to other income classes. For example:

> If a person in the 70 percent bracket gives a sum of money, he is able to deduct that sum of money from his tax base, and in effect he is only giving 30 percent, whereas when a person in the 14 percent bracket gives a sum of money, he is giving 86 percent. Or to put it differently, if a $200,000 person gives 10 percent of his income to charity, it really costs the government $14,000 to get $6,000 out of that person. . . . If a $12,000 person gives 10 percent of his income to charity, it costs the government $324 to get $876 from this person. The charitable deduction works just upside down. (Filer 1975, p. 109, quoting Surrey).

Financial Benefits

Despite the apparent inequity in this system of charitable deductions, the higher education community supports its continuance because it provides colleges and universities with important channels of financial support. Advocates of the present system also argue that first, the inequities lie in the progressive tax rate rather than the system of deductions; and, second, money given to charity is not used for personal consumption, and therefore, should not be subject to taxation (Filer 1975). Finally, they contend that if the present system did not exist, substantial contributions to colleges and universities would be lost. They charge that the tax breaks under the present system provide a major incentive for large gifts.

Records of contributions to colleges and universities appear to bear this out. These show that a disproportionate share of gifts to institutions comes from a very small segment of the population. In 1973-74, for example, large gifts, identified as contributions over $5,000, represented 0.44 percent of all giving, but produced 70.84 percent of all voluntary support to colleges and universities (Levi and Steinbach 1975). Moreover, a substantial proportion of these gifts evidently are designed to use the tax advantage provided for donations to 501 (c) (3) organizations. Taxes on estates, appreciated securities, real estate, and other property may be reduced by donating cash or these instruments to an institution. In 1973-74, 98 percent of all large gifts were in the form of bequests, and 41 percent of these were in securities, real estate, and other property (Levi and Steinbach 1975).

"Above-the-Line" Legislation

Taxpayers who do not itemize but take the standard deduction instead cannot take advantage of deductions for charitable giving. Since 1968, this group of taxpayers has grown substantially, from 52 percent of all taxpayers in 1970 to 77 percent in 1978 (National Association of Independent . . . 1978b). Some analysts argue that this erosion of the standard deduction has reduced the incentive for charitable giving; they estimate that in 1977 alone, gifts to charity would have been $1,375 billion more if the standard deduction had not increased since 1970 (NAICU 1978b).

Faced with this financial dilemma, charitable organizations strongly support "above-the-line" tax legislation that would provide special incentives for charitable giving. Such legislation is now pending before Congress (H.R. 1785 and S.219). It would permit nonitemizing taxpayers a deduction for charitable contributions much as they are now allowed to credit such expenses as child care, alimony, and moving.

There are several objections and counterproposals to this legislation that makes its passage uncertain. First, opponents argue that this additional deduction will cost the federal treasury too much—between $2 to $3 billion. Advocates point out this loss will be offset by greatly increased revenues to the charitable sector: charities will gain about $1.15 to $1.30 for each dollar lost to the Treasury (United Way 1979). Second, other groups support the general concept of enhancing charitable giving but prefer tax-credit legislation, which would provide a 30-percent credit for charitable contributions. They charge that the "above-the-line" proposition perpetuates an already inequitable system of deductions that give greater benefits to those in higher income brackets. A tax-credit plan would give each taxpayer the same incentive for giving (Bothwell 1978). Advocates of the deduction approach respond that tax credits would substantially reduce the giving of those in the higher income brackets; for example, a 17-percent reduction in giving to educational institutions would result if a 30-percent credit were introduced (National Association of Independent . . . 1979).

Section 117

Section 117 of the Internal Revenue Code presents tax problems of unique interest to the higher education community because it regulates college and unviersity scholarships and fellowships. Section 117 excludes from gross income any fellowships or scholarships; however, the exclusion does not apply to:

> that portion of an amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. However, this limitation does not apply where teaching, research or other services are required of all candidates . . . for a particular degree as a condition to receiving the degree (Hopkins 1975, p. 55).

The Section 117 exemption has stirred continuous controversy because it does not carefully define "fellowship" and "scholarship"; that is, it does not address the many cases where an educational institution grants a fellowship to a student for rendering services to the institution that, at the same time, further his own learning and enable him to meet program requirements. Section 117's lack of specificity leaves taxpayers and the Internal Revenue Service in doubt over whether the payment given is a true fellowship or belongs to the excluded category, discussed above. As a result, the Internal Revenue Service, the courts, individual taxpayers, and the Congress have engaged in case-by-case decision-making over what constitutes a *bona fide* fellowship or scholarship.

This has proven to be an inefficient and costly process* that calls for clarification and Congressional direction. Two problem areas in particular need to be addressed.

Payment for services—A 1969 Supreme Court decision, *Bingler* v. *Johnson* (394 U.S. 741), establishes the guidelines by which the Internal Revenue Service judges whether a fellowship or scholarship is excludable income. Under this decision, any "fellowship" or "scholarship" that requires *"quid pro quo"* is not excludable from gross income for taxation purposes: "bargained-for payments, given only as a *quo* in return for the *quid* of services rendered—whether past, present, or future—should not be excludable from income as 'scholarship funds'" (394 U.S. at 757-5758).

As a result of this decision, the Internal Revenue Service has followed a policy of treating any fellowship or scholarship that requires some work or service in return as a *"quid-pro-quo"* relationship and disallowed the Section 117 exclusion, even for degree candidates (Hopkins 1975). There has been considerable litigation in this area, since Section 117 (b) (1) requires the service element to be discounted when determining fellowship status if the service is required of all degree candidates.

Many student-employees have contested the applicability of *Bingler* v. *Johnson* to their situations. Most often, resident physicians and graduate teaching fellows become involved in disputes when they "seek to exclude from their income compensation received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor" (*Changes Needed . . . 1978*).

In late 1978, there was a flurry of activity on this subject after the release of the General Accounting Office's report on tax treatment of fellowships, scholarships, and education-related expenses (*Changes Needed . . .* 1978). The report proposed specific changes in the tax law with which the Treasury Department disagreed. For its part, Treasury offered its own recommendations. Congress has taken no action on this issue, but these proposals for changes in the law suggest future directions for Section 117.

Under the General Accounting Office's (GAO) plan, the conditions under which a fellowship or scholarship would be excludable from gross income would be severely restricted. Its new Section 117 would not distinguish between degree and nondegree candidates and would consider all scholarship and fellowship grants as part of gross income, unless a grant meets *all* statutory requirements for exclusion. Excludable grants would be those that are: (1) limited to the cost of tuition, meals, room, travel, books and equipment, and clerical help; (2) select grantees on the basis of scholastic merit, achievement, or financial need; (3) do not require the recipient to render present or future services as a condition for receiving the grant; (4) do not represent compensation for past services; and (5) have as a grantor a specifically approved organization, such as Section 501 (c) (3) organizations. (*Changes Needed . . .* 1978).

In response to these GAO proposals, the Treasury Department recommends changes that are much less radical. It recognizes the considerable controversy under Section 117, but suggests that the GAO's solution, while easing administrative problems, does not promote the concept of equity (Lubick and Kurtz 1978). Instead, it offers three alternatives to the GAO plan. First, a revised Section 117 could limit excludable income to tuition and fees, books, and other education-related but nonpersonal expenses. The impact on most scholarship recipients would be minimal, since education-related expenses account for the bulk of most grants and the remainder is too small to be taxed. Second, Section 117 could apply to tuition, fees, and living expenses of degree candidates only. This step would eliminate a large number of cases now in question. Finally, Congress could impose a limit on excludable income similar to that presently in effect for nondegree candidates.

Tuition Remission—Tuition-remission programs, tuition benefits for children of college faculty and staff, are treated as scholarships granted to students and are therefore exempt from taxation under Section 117. But since 1975, the Treasury Department has questioned the tax-exempt status of tuition-remission programs as part of its larger investigation into the tax-exempt status of many fringe benefits granted to employees. Its efforts to revise treatment of fringe benefits have drawn considerable opposition, and Congress imposed a freeze on any changes in fringe-benefit treatment until it could consider the issue. This moratorium has recently been extended until June 1, 1981.

The major issue is whether tuition remission programs are a fringe benefit to faculty or a scholarship to students. Tuition remission programs became popular during the 1930's when institutions provided tuition-free education at the home institution to children of faculty. Eventually, the concept developed into three types of tuition remission programs, which are now widely available to faculty and staff families: (1) tuition-remission scholarships at the instituiton where the parent teaches; (2) tuition-exchange scholarship programs where the parent does not teach; and (3) tuition-grant scholarship programs, in which the sponsoring institution issues a check in favor of the admitting institution. In most cases, tuition-remission programs provide tuition-free education for eligible students. At some high-cost institutions students may have to pay part of their tuition costs; and the tuition-grant program generally does not pay for all tuition costs (Smart 1978).

The Treasury's discussion of how fringe benefits serve the employee would appear to place tuition-remission programs in the fringe-benefit rather than the scholarship category, since faculty and staff salaries are generally lower than professional salaries elsewhere. Testifying before the House Committee on Ways and Means, the Assistant Secretary of the Treasury for Tax Policy argued that fringe benefits may represent "[c]ompensation received in kind [that] may be just as valuable as compensation received in cash" (Lubick 1978, p. 2). Further, a tax-exempt fringe benefit may be more valuable than cash compensation to an employee, thereby providing the employer with an incentive to provide tax-free benefits in lieu of cash. Finally, employers may use tax-free fringe benefits as a competitive advantage; that is, employees may be willing to accept less total compensation if a portion is in tax-free fringe benefits than if all compensation is in cash. In effect, employees may stay in or move to job markets that offer attractive, tax-free fringe benefits.

The higher education community contests the concept that tuition-remission programs are a fringe benefit rather than a scholarship program. Advocates for the present treatment note that tuition-remission programs have been regarded as scholarship programs since the income tax was imposed. The legislative history of Section 117 indicates that Congress intended to maintain this tradition:

> "If an educational institution . . . maintains or participates in a plan whereby the tuition of a child of a faculty member of any such institution is remitted by any other participating institution . . . attended by such child, then the amount of tuition so remitted shall be considered as a scholarship under this subsection (Steinbach 1978, citing House Report 1337,

*For the fiscal year ending June 1976 alone, the Internal Revenue Service's records show that 6.8 percent (or 2,679 cases) of individual tax cases contested at the district level (within the IRS) were concerned with the fellowship or scholarship exclusion issue (*Changes Needed . . .* 1978).

83rd Cong. 2d Sess., (to accompany H.R. 8300) A36 (1954); Senate Report 1622, 83rd Cong., 2d Sess. 188 (1954)].

In addition, tuition-remission programs meet the scant criteria provided in Section 117 and Internal Revenue regulations. Section 117 merely excludes from gross income any amount received as a scholarship at an educational institution. Treasury regulations define a scholarship as "an amount paid or allowed to for the benefit of a student, whether an undergraduate or a graduate, to such individual in pursuing his studies" (Treasury Regulation Section 1.117-3(a)).

Most important, higher education officials argue that the primary purpose of tuition remission programs is to promote the recipient's education, rather than grant an employee benefit. They note that faculty and staff salaries are not adjusted or negotiated on the basis of tuition-remission programs nor is future employment a condition for the tuition remission benefit (Steinbach 1978).

Observations

Looking at tax-reform issues from an Olympian perspective, the New York Times (1977) editorialized:

> The basic purpose of the income tax is to collect revenue—and that motive should dominate the writing of a new tax code. . . . The habit of using personal and corporate taxes as levers for social change has become almost irresistible. Government has been taxing with one paragraph of the code, giving rebates with the next, and creating inequities with every phrase.

But legislative history, cultural values, and current politics argue against any wholesale reform of the tax code; yet, piecemeal efforts have been made to alter the code and this practice most likely will continue.

The higher education community views these reform efforts with concern because some proposed changes may adversely affect the tax benefits available to them. Washington education watchers therefore continually monitor congressional activities in tax areas that affect their special interests. They have a powerful ally in other special-interest groups, particularly in the nonprofit sector, which are also interested in maintaining tax provisions that encourage charitable giving. Collectively, these forces may be able to bring about change in their own self-interests.

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